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**The Financial and Monetary Crisis: Rethinking Economic Policies and Redefining the Architecture and Governance of International Finance**

Effective Demand: Uncertain expectations, profitability and financial crisis

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Paper to be presented at the conference:

# **“The Financial and Monetary Crisis: Rethinking Economic Policies and Redefining the architecture and governance of international finance”**

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## **Effective Demand: Uncertain expectations, profitability and financial crisis**

by

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*Keynes's vision, which one can trace back to his youth, has to do with the logic of choice, not under scarcity, but under uncertainty (Skidelsky, 1992:538)*

*By "very uncertain" I do not mean the same thing as "very improbable". (Keynes, 1936:148).*

*[T]he point of the aggregate demand function, where it is intersected by the aggregate supply function, will be called "the effective demand" (Keynes, 1936: 25)*

### **Summary**

The principle of effective demand is the most distinct macroeconomic novelty within *The General Theory*. It can only be understood as a consequence of decision making in a business environment characterized by fundamental uncertainty. Entrepreneurs do not know, and cannot know, what the future will bring with certainty. On the other hand they have to make decisions on production, investment and employment which take time and range into this uncertain future.

In this paper I will trace the impact of uncertainty on effective demand in four dimensions: expected aggregate demand, supply price of production (profitability), the role of bank credit and finance and rather briefly the availability of supply factors and the role of sustainability.

The analytical procedure takes departure from within Critical Realism, because the social ontology of the business environment is considered as characterized by uncertainty – that we simply cannot know the future. How can sustainable development and the impact of the macroeconomic growth process be analysed meaningfully given these methodological conditions?

It has become a part of the *critical realist* and post-Keynesian interpretation of *The General Theory* (1936) to stress that the social ontology of the macroeconomic reality is only partly visible and indeterminate which is reflected in a path-dependent development through historical time. This constantly changing macroeconomic environment is at best understood through the lenses of an open system, where uncertainty is given a prominent role as an integrated analytical part. This has to be so, because, uncertainty is all over the place. That is the epistemological challenge when a *realistic* macroeconomic theory like the ‘principle of effective demand’ is investigated.

## Introduction to ‘uncertainty’.

### a. At the macro level

*Keynes’s perception was that economies did not behave in the way economists said they did, that something vital had been left out of their accounts, and it was this missing element which explained their malfunctioning; Keynes accused economists of his day of abstracting from the existence of uncertainty* (Skidelsky, 1992: 538-9).

Keynes developed his understanding of uncertainty throughout his economic writings. *A Treatise on Probability* from 1921 was mainly about individual decision making in an uncertain environment dependent on what information was available. Through the 1920’s Keynes got a vast number of practical experiences from his work in the financial sector, which was a great source of inspiration to develop his theory of ‘liquidity preference’ – how institutional organisation, individual uncertainty and different ‘degrees of confidence’ could explain parts of the working of the financial markets, of the transmission of monetary policy and of the development in the long term rate of interest.

But it was not until he had finished the writing of *A Treatise on Money* (1930) that he fully realised that the role of uncertainty had much wider implications. During the early 1930’s he started to doubt that a realistic macroeconomic analysis could be kept within the boundaries of a closed model analyses. Because, if uncertainty plays a significant role at all stages of decision making, then coordination failures are unavoidable in this ever changing macroeconomic environment. Stability (not to speak of general equilibrium) would be like a mirage. In stead, the macroeconomic system will find itself moving along a continuous path-dependent route, where a terminal point is at best unknowable, but more likely not existing.

It has become a part of the *new* post-Keynesian interpretation of *The General Theory* (1936) to stress that the social ontology of the macroeconomic landscape is only partly visible and guided by causal mechanisms which make a path-dependent track record through historical time (Jespersen, 2009a). This constantly changing macroeconomic development is at best understood through the lenses of an open system, where uncertainty is given a prominent role as an integrated analytical part. This has to be so, because, uncertainty is all over the place. That is the epistemological challenge to realistic macroeconomic theory.

*Economics is a science of thinking in terms of models joined to the art of choosing models which are **relevant** to the **contemporary world**. It is compelled to be this, because, unlike the natural science, the material to which it is applied is, in too many respects, not homogeneous through time, (CWK, XIV, 1937: 296/97, my emphasis)*

## **Individual uncertainty with some macroeconomic implications**

Uncertainty is caused by lack of information. Therefore uncertainty might have different intensities or 'states of confidence'. You may feel(!) more or less uncertain, but except for rare cases all individual activities are characterized by (different degrees of) uncertainty, because one cannot know nor estimate the exact outcome. Hence, expectations are uncertain due to this inherent lack of information (and a constantly changing environment).

Risk is defined as measurable uncertainty. If an identical activity is undertaken by a large number of people who act independently of each other, e.g. natural death, then an exact outcome might be calculated with regard to the macro-outcome of the entire population. In these cases a private insurance company or some other institution, which reduces the individual uncertainty with regard to specific outcomes, might be established at a profitable basis. In the society in which we live, one can take out an insurance against the narrow economic consequences of e.g. theft, fire accidents and death. Buying an insurance imply that individual uncertainty, with regard to the money aspects of such incidents, is removed. But, as we know, most activities have also unforeseeable consequences. Therefore, even a well designed insurance contract can only reduce the degree of uncertainty, because it goes against the idea of a private insurance company to accept commitments which imply incalculable risk, i.e. uncertainty.

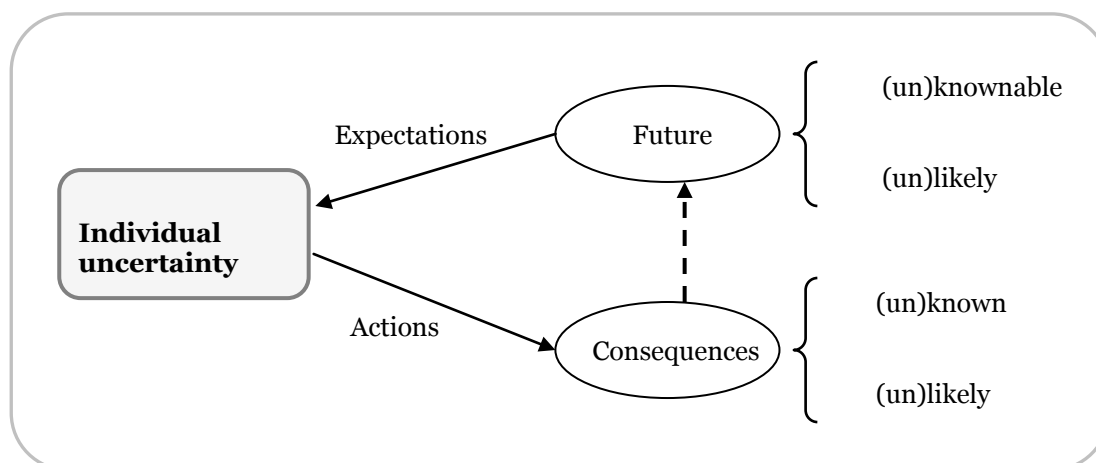
One important conclusion is that privately organized business can never change individual uncertainty into socially calculable risk. The real value of financial savings will always be uncertain, because no one can predict the future inflation, which is characterised by macroeconomic uncertainty. Even the average living age of human beings is statistically unpredictable, which a number of pension funds regretfully have realized.

If the consequences of individual uncertainty are not understood there is an acute risk of committing the fallacy of composition, Jespersen 2009a: chapter 7.

At the individual level there are three obvious appearances: Individuals act

1. without having full information about their immediate environment
2. without much knowledge of the macroeconomic context and other decisive parameters for decisions (e.g. economic policies)
3. without have full knowledge about the consequences of our actions

### **Figure 1: The anatomy of individual uncertainty**



Source: Jespersen (2009): chapter 4

We are all, as individuals, acting without knowing the exact consequences, and we act without having full information about external factors, which have an impact on the outcome. We cannot know the future, because the macroeconomic reality is (partly) hidden. It cannot be experienced, before it is too late to act, (Jespersen, 2009a: chapter 2). Hence, it is misleading and pretentious to assume that agents have full knowledge about the future – so-called rational expectations. In fact, to assume rational expectations in macroeconomics is not in any real analytical sense rational – one may rather say that ‘it is to assume our difficulties away’, (Keynes, 1936: 34).

What are the implications for realistic macroeconomic analysis that people act under uncertainty – which can take the form of a variety of different perceptions with regard to information of the past, of the present and of expectations about the future? They try to behave as rational as possible by following conventions, group behaviour and setting up institutions which are intended to reduce/share the unforeseeable and unpredictable consequences of lack of information and external events. Even though information and consequences are uncertain, decisions have to be undertaken continuously: production, consumption and investment cannot be postponed until uncertainty has been cleared. If we ask for certainty as a precondition for acting – then we cannot act, which, on the hand, in some way is an act by itself. Hence, anyone has to act one way or the other on the back-drop of uncertainty. The really intriguing question is then, how to make a proper macroeconomic analysis, where uncertainty is given the epistemological role which it deserves.

Keynes’s *Principle of Effective Demand* developed in *The General Theory* is an example of such an open system analysis, which incorporates uncertain expectations at the individual/ business level and transfers them into a coherent macroeconomic theory of output and employment as a whole.

## The Principle of Effective demand

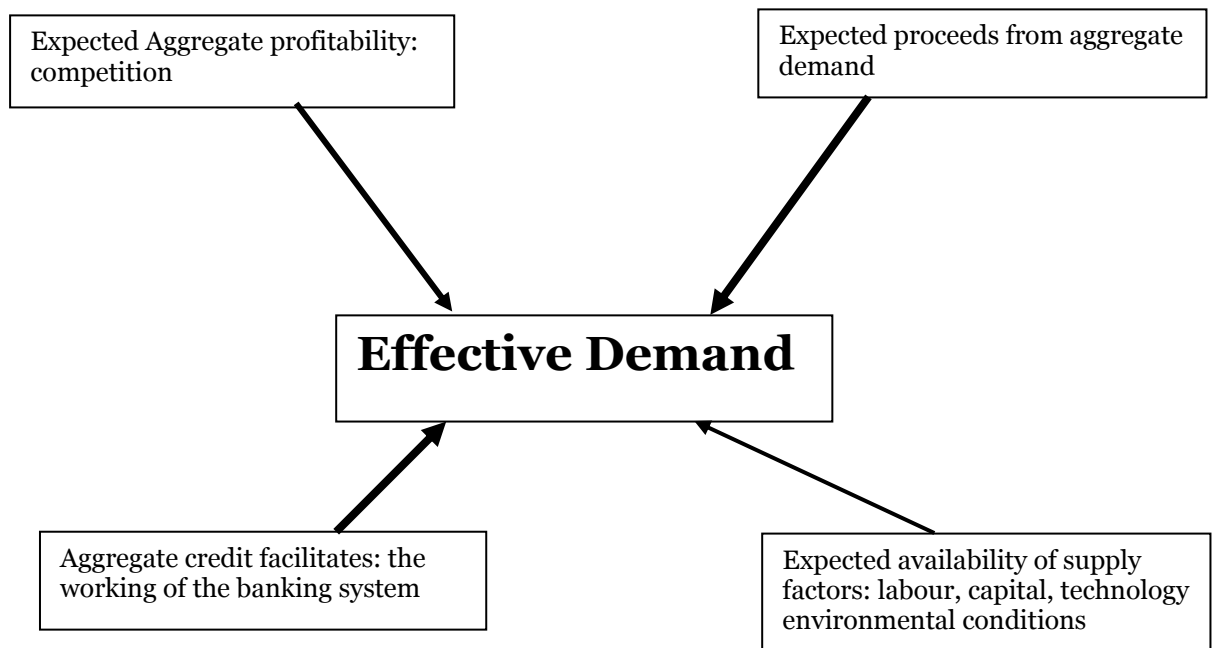
*As I now think, the volume of employment is fixed by the entrepreneur under the motive of seeking to maximise his present and prospective profits; whilst the volume of employment which will maximise his profit depends on the aggregate demand function given by his expectations of the sum of the proceeds. (Keynes, 1936: 77)*

*Effective demand* is one of the distinctive analytical concepts that Keynes developed in *The General Theory*. Demand and demand management have thereby come to represent one of the distinct trademarks of Keynesian macroeconomic theory and policy. It is not without reason that the central position of this concept has left the impression that Keynes's macroeconomic model predominantly consists of theories for determining demand, while the supply side is neglected. From here it is a short step within a superficial interpretation to conclude that Keynes (and post-Keynesians) have ended up in a theoretical dead end, where macroeconomic development is exclusively determined by demand factors.

Fortunately, a rich post-Keynesian literature on 'Effective demand' has emerged during the last years overcoming the above mention misinterpretation and adding more arguments to the subtle analytical concept than in fact can be found in *The General Theory*, see for instance Hartwig, 2007 and Gnos, 2009.

As mentioned, the intention of this paper is to give an example of how an important macroeconomic causal relationship can be modelled on the basis of both supply and demand factors with the inclusion of specific institutional conditions such as different forms of competition. The choice of the analytical method plays a determining role for the macroeconomic 'behaviour' that can be deduced on the basis of an aggregate model-structure based on the assumption of rational microeconomic behaviour under condition of uncertainty within a relevant institutional context and supported by empirical observations. Obviously, this methodological procedure is contrary to methodological individualism, where representative agent within a given market structure optimize with full information about the general market clearing solution

## **Figure 2: Outlines for the macroeconomic principle of effective demand**



**Explanation of the figure:** Effective demand determines how much output and employment the business sector as a whole plan to undertake in the next ‘production period’. It consists of (at least) four analytical components:

1. Expected (by the business sector) aggregate demand in money terms
2. Expected (by the business sector) costs and likely profitability in money terms, dependent on the degree of competition
3. Bank credit facilities and costs (rate of interest ect.)
4. Availability of factors of production

In any case, it is the behaviour of profit-seeking firms acting under the ontological condition of uncertainty that is at the centre of post-Keynesian concept of effective demand. It is entrepreneurs’ *expectations* with regard to demand **and** supply factor that determine the plans for output as a whole and by that the *effective demand* for labour.

Therefore, it was somewhat unfortunate that Keynes called his new analytical concept ‘effective **demand**’, which may have contributed to mislead generations of open minded macroeconomists to concluding that it was exclusively realized *demand* for consumer and investment goods that drives the macroeconomic development. Hereby a gateway for the IS/LM-model interpretation of effective demand was opened, where demand creates its own supply.

On the contrary, it is the interaction between the sum of the individual firms’ sales expectations (aggregate demand) and their estimated production costs (aggregate supply) that together with a number of institutional conditions (bank credit, labour market

organization, global competition and technology) determine the business sector decisions on output as a whole and employment.<sup>1</sup>

Thus, it is my intention with this paper to eradicate the often presented point of view that Keynes's macroeconomic theory does not have microeconomic or supply side considerations. In fact, *Keynes's economics is a theory of rational choice under uncertainty*, Skidelsky, 1983.

### **Firms' uncertain expectations determine 'effective demand'**

The supply side in the goods market is an aggregate presentation of firms' cost functions considered as a whole. It shows a relation between what Keynes called 'supply price', i.e. the sales proceeds that, given the production function and cost structures, is needed to '*just make it worth the while of the entrepreneurs to give that employment*' (Keynes, 1936: 24). This means that behind the supply curve there is a combination of variable costs plus an expected profit at different levels of employment. At each level firms try to maximise their profit, if they succeed there is no (further) incentive for firms to change production or employment.

These assumptions entail that the *aggregate supply function* (what Keynes called the Z-curve) is upward sloping and represents the proceeds that has to be expected by the industry as a whole to make a certain employment 'worth undertaken', see the Z-curve in figure 3. In fact, this *aggregate supply function* looks like it was taken directly from a standard, neoclassical textbook, where *decreasing marginal productivity of labour* in the representative firm is assumed; the main difference is that Keynes is dealing with the aggregate sum of heterogeneous firms i.e. the industry as a whole.

The other equally important part of effective demand is *aggregate demand function*, which is the value of the sales that firms as a whole *expect* at different levels of macro-activity measured by employment (as a whole).

In order for firms to act on the best information available they have to form expectations about future sales which have to be both empirically based and forward looking at the same time: *let  $D$  be the proceeds which entrepreneurs expect to receive from the employment of  $N$  men, the relationship between  $D$  and  $N$  being written  $D = f(N)$ , which can be called the Aggregate Demand Function.* (Keynes, 1936: 25, my emphasis).

It is a definition of few words that opens the possibility for a number of hypotheses with regard to how the entrepreneurs' total expectations of proceeds are formed. But to me it seems undeniable that Keynes is speaking about a macroeconomic relationship. How much money will be spent on consumption and investment at different levels of activity (measured by employment)?

The concept of aggregate demand can perhaps be best understood with reference to the far newer statistical concept of a 'business sentiment index'. The business sentiment index is based on a survey among a cross-section of firms of their expectations about sales in the nearer future. This published index helps to form expectations of sales proceed for the industry as a whole or even for the entire macro-economy. It is assumed that on this basis, the firms form a kind of consensus-expectation with regard to the most likely

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<sup>1</sup> Adding the institutional conditions is an extension compared to Keynes's presentation in *The General Theory*.



development in sales (considered as a whole) in the nearer future.<sup>2</sup> This in some way consensus-expectation (aggregate demand) is a useful point of departure for the *individual* firms when they form their specific expectation of future sales. This sales expectation<sup>3</sup> will therefore especially centre on the future *macroeconomic* demand (and today we would also add international competition).

Accordingly, Keynes's *macro*-theory has a microeconomic foundation of firms trying to maximise profit, but differs from neoclassical theory by introducing uncertainty related to the future, which makes an explicit introduction of *aggregate demand* relevant i.e. the *expected sales proceeds by business as a whole*.

One possible interpretation of the behaviour of the individual firms is that they do not consider the firm specific demand as infinite at a given market price, see Hartwig, 2007. In the short run they have to behave under the constraint of a rather fixed market share and a fixed capital stock. In this case it is not rational for individual firms to plan production as though it operates on a horizontal demand curve and should not expect the market price to be solely given 'from outside', not to speak about being constant. This means that the neoclassical assumption of firms exclusively adjusting the production on the basis of a given price and cost structures leaving demand neglected can be discharged, when uncertainty prevails. In the short run firms know that the aggregate demand at the macro-level is limited and prices flexible, which has to be included in the individual firm's production planning. This analytical semi-closure of firms operating under the constraint of a limited market share makes it relevant to assume firms as a whole to behaving like a monopolistic competitor who has to react on a change in aggregate demand. In addition, the aggregate macro-behaviour is not in dissonance with the assumption the individual firms try to maximize profit given the available, but uncertain knowledge about the future: costs, sales proceeds, market share and competitive conditions (domestic and foreign).

In this case it has been explained, why post-Keynesian economics has dismissed the neoclassical abstraction that the macro-supply curve can be presented by the behavioural relationship of one representative micro-firm. In post-Keynesian theory firms are assumed to behave with respect to their uncertain knowledge about aggregate demand (demand as a whole), and that they can only achieve a (un)certain share of this aggregate demand. Hence, demand is *not* unlimited for the individual firm, i.e. the individual demand curve is *not* horizontal within Keynes's principle of effective demand.

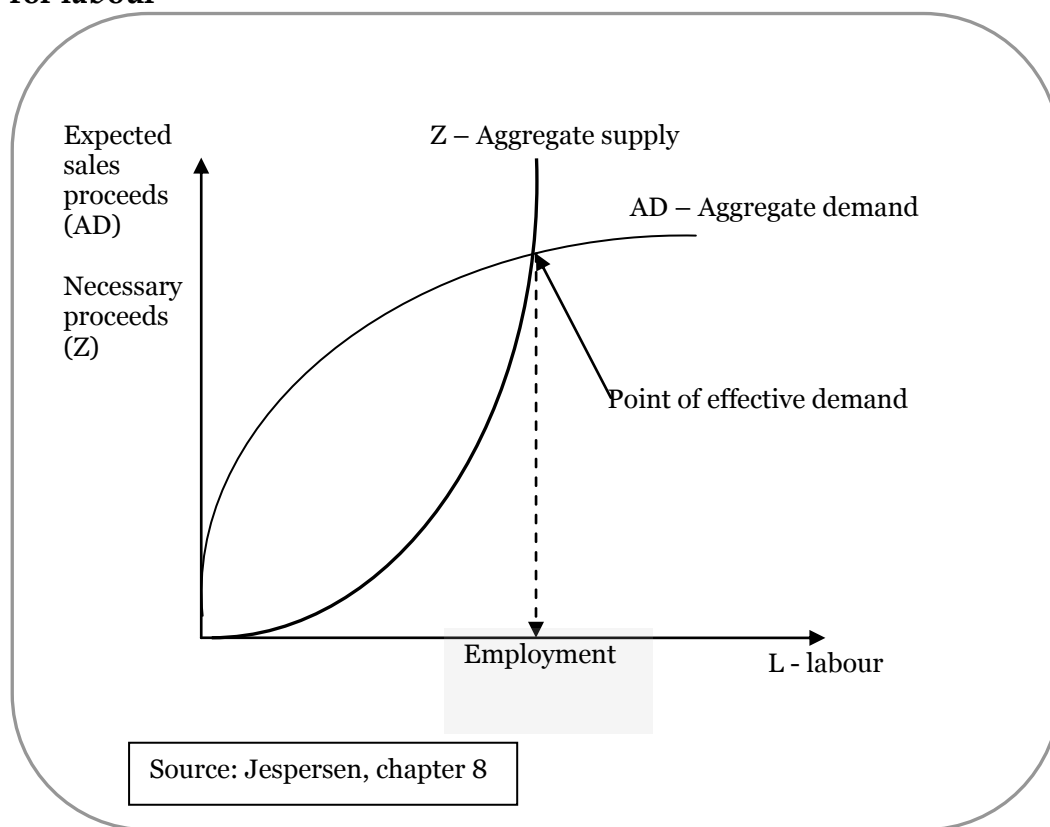
Finally, it is important for Keynes to make clear that aggregate supply and aggregate demand are two clearly separated entities. Keynes's main objection against 'classical' theory is exactly, that it equates the macro-supply and macro-demand functions in such a way 'that supply creates its own demand'. But the conclusion that demand creates its own supply is equally misleading

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<sup>2</sup> 'nearer future' means analytical a period that corresponds to the time of implementation decisions related to hiring and firing in the labour market.

<sup>3</sup> How the total sales would be distributed among the individual firms within the branch would be of lesser importance in a macroeconomic perspective.

**Figure 3. Aggregate supply and aggregate demand together determine *effective demand* for labour**



## The impact of competition

The degree of competition on the output-market determines the size of profit that can be achieved by the entrepreneurs. Post-Keynesian literature therefore distinguishes between two distinct market forms: *perfect competition* and *monopolistic competition*. This distinction leads to different results with regard to the size of profit and to how much employment a certain level of aggregate demand can be expected to generate in the short run. One of Keynes's main points was precisely to demonstrate that his theory was 'general', that it was valid no matter what form of competition prevailed on the goods and labour markets<sup>4</sup>. In fact, effective demand is a relevant analytical concept even in cases where firms were not profit maximising. Probably, he chose to assume profit-maximising behaviour and perfect competition even on the demand side of the labour market out of analytical convenience rather than realism.

As mentioned above Keynes did in 1936 undertake his macro-analysis under assumption of 'perfect' competition in the sense of real wage being determined by marginal productivity – goods prices are given from outside the individual firm while the

<sup>4</sup> The post-Keynesian literature distinguishes between 'fundamental-Keynesian' and 'Kaleckian' (named after the Polish-born economist Michal Kalecki, 1899-1970) economics - an often rather subtle distinction, King (2002). With regard to pricing on the goods market two different principles are assumed: marginal cost pricing and mark-up pricing respectively, which can be attributed to two different competitive conditions. The distinction is not important, since Keynes can be interpreted as covering both market forms, which not least Keynes (1939) confirms. For Keynes it became increasingly important to understand reality which made him in this respect come closer to the mark-up pricing assumption like Kalecki.

aggregate demand had to be shared between firms in the market for final goods. In that case effective demand is determined as the intersection point between aggregate supply and aggregate demand, which also determines the analytical 'profit-equilibrium' (CWK, VII: xxxiii). At the point of effective demand there will be no inherent tendency in the business sector to change production or employment, because firms are assumed to maximise profit, as illustrated in figure 3.

Conversely, it can be illustrated that increased competition may in the short run make a lower level of profit acceptable and in the longer run reduce production costs, which push the supply curve downward. Hence, globalisation could cause employment to increase if the generally required profit level was reduced due to increased competition. Furthermore, globalisation might also lead to increased real wages, which could boost aggregate demand.

The analytical separation of aggregate demand and aggregate supply improves the understanding of the forces behind a change in the *principle of effective demand*. Uncertain expectations introduce a wedge between expected demand and required profit. Increased competition means that although firms still profit maximize the profit margin of the business sector as a whole has been reduced. That might have an impact on the expectation proceeds, because a higher wage sum means more purchasing power per employed person.

The principle of effective demand works equally well under assumption of monopolistic competition, because firms have in any case to act as though the production capacity and aggregate demand is limited in the short run for the industry as a whole, which at the end of the day is a much more realistic assumption.

## The importance of bank credit

Keynes's presentation of the 'principle of effective demand' came rather early in *The General Theory*, chapter 3 and 5. Both aggregate supply and aggregate demand was defined, as explained above, in money terms. Keynes spoke about the supply price of output (Z-curve) and the expected proceeds of sales (AD-curve); but Keynes did not at that early stage take into consideration the financial aspect of output taking time to be produced. Of course, he was fully aware that production takes time from the moment it is decided upon until it is sold in the shops. The passing of time causes uncertainty, because firms do not know with any kind of certainty what proceeds the output will generate.

But there is another important aspect of production and consumption not coinciding. Production has to be financed in a way that firms are able to pay the factors of production by means of payments. This requirement gives the private banks a unique role when effective demand has to be realized. Firms can only use bank credit as working capital, because bank credit is considered as means of payments. Financial institutions which have the specific position that their liabilities possess the ability of being accepted as means of payments, we call banks. Bank deposits are used as money (in the sense of means of payments).

This is the important contribution by the *monetary circuit theory*: effective demand cannot be realized unless there is access to working capital in the forms of means of payments, Graziani (2002). What matters are financial assets considered as generally accepted means of payment. Of course, Keynes had that perspective in mind, when he in 1933 changed the heading of his lectures held in Cambridge from 'a pure theory of money' into 'a monetary theory of production'. Money and real sector activities cannot in any

meaningful analytical sense be separated. In some way Keynes had anticipated that conclusion, when he wrote *A Treatise on Money* (TM), published in 1930. Here he demonstrated that a well functioning banking system could provide whatever means of payment that was needed for serious business purposes. Therefore, money had not to be a constraining factor, because of the build in endogeneity within the working of the banking system as a whole. In fact, to stabilize the money creating process there are good arguments to separate 'business banks' from other financial institutions. In his TM Keynes argued, that *industrial circulation* (current deposits by business banks) should be separated from *financial circulation* (savings deposits and (perhaps) treasury bills). *Industrial Circulation* and only that should have the status of means of payments (together with central bank notes), see Jespersen (2009c).

On the other hand if the banking system is not well functioning, which was overwhelmingly demonstrated in the aftermath of the collapse of Lehman Brothers investment bank, bank credit suddenly became a co-determining and constraining factor on effective demand. Effective demand shrunk due to a fall in working capital. The z-curve could not be financed by bank credit as usually! The business sector had to improve on its profit rate to become less dependent on the banking sector. This increased profit mark-up made the z-curve swing to the left in the diagram. Furthermore banks raised their rate of interest which made working capital more expensive and added to the amount of necessary proceeds. No wonder that the effective demand did fall immediately, when the business sector could not get the usually working capital. Hence, less people were employed and the usual multiplier effect entailed in the AD-curve started to work backward.

[How could a part of the industrial circulation suddenly disappear? Simply, because one of the largest US investment banks suddenly went bankrupt. It had debt close to \$600 bill. and only own capital of \$ 22 bill. (Wikipedia). Registered loss in 2008 was \$ 7 bill., but with more to come. Lehman Brothers was heavily dependent on short term borrowing in the interbank market, when it was denied access to that market and the Fed turned it down due to too little collateral, the game was over. The bank became illiquid over night, probably do to insolvency. Deposits in Lehman Brothers were no longer liquid, because at that time there was no general federal deposit guaranty. They were frozen until assets of Lehman Brothers were sold and the over all account settled which could take years.]

## **Availability of supply factor: labour, capital, technology and environmental conditions**

*The sense in which I am using the term [uncertainty] is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970. About these matters there is*

*no scientific basis on which to form any calculable probability whatever. We simply do not know (Keynes, 1937: 113).*

### **Increased real capital**

Keynes had little to say about the availability of supply factors: labour, capital, technology environmental conditions not to speak of macroeconomic growth, which is quite understandable taking the economic situation in the first half of 1930's into consideration<sup>5</sup>. On the other hand Keynes was very conscious about the importance of long-term expectations for the undertaking of real investment; but as Keynes said in 1937 – what can we know with certainty about any important matter 30-40 years ahead? - 'about these matters there is no scientific basis on which to form any calculable probability whatever'. Keynes was working within the framework of an open system, where the degree of uncertainty increases with the length of the planning horizon.

In *the General Theory* Keynes had analysed the main driving factors within a macroeconomic path which was not in general supply constrained; but he did not make an explicit analysis of the capacity increasing implications of real investment. Post-Keynesian economics were left alone with regard to growth theory. Harrod (1939) made an attempt to overcome the gap in *The General Theory* of real investment being demand augmenting without having a direct supply effect. Harrod could have made some arguments related to the Z-curve, how it might take as a consequence of enlarged capital or improved technology and by that making the principle of effective demand capturing some of the dynamics derived from increased productivity. However, Harrod kept his theory within an analytical framework of a closed system, where planned investments were assumed to be similar to realised saving. There was within this analytical model no room left for individual uncertainty, although the model demonstrated an inherent instability due to lack of substitution between factors of production and lack of stabilisation policies.

In real life real investment is partly undertaken due to convention (what to do with profits), and partly due to animal spirit (an entrepreneur acting more like an artist than a stereotype capitalist). But, when real investments have been decided and are on stream, future business activities will be influenced by these investments, because the macroeconomic development is path-dependent. Yes, endogenous growth theory is relevant also when uncertainty prevails. Hence, business cycle and growth trend cannot be separated. Firms invest in boom periods due to increased profit and optimism, whereas disappointed expectations will often have a negative effect through reduced state of confidence.

### **The long-term productivity and sustainable development**

As far as I know, Keynes never wondered about the relationship between growth and exploitation of natural resources. In the inter-war period the supply of coal was vast and oil becoming more plentiful. Although the smog in larger industrial areas was already in the 1930s a daily nuisance, but the alternative of a life without coal would have been

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<sup>5</sup> One of the few exceptions is the beautifully written essay on *the Economic Possibilities of our Grandchildren* published in 1930 and included in CWK, IX, where Keynes just plaid with the idea that economic growth could go on forever fuelled by the ever increasing productivity.

unbearable. Of course, Keynes had noticed that the overall productivity had increased considerably even through the years of depression<sup>6</sup>.

Increased productivity was in no way a new phenomenon. Looking at the macroeconomic development throughout the past two centuries would also have demonstrated a constantly increasing real wage and real production. The market-economic system had been able to display continuously increasing productivity *per capita*, often in combination with reduced working hours. The reasons for the increased labour productivity are manifold (increased capital stock, education, innovations **and exhaustion of natural resources** among other things), which has increased the supply side capacity. Increased productivity reduces unit labour costs, which – *ceteris paribus* – increases the effective demand for production, but does not necessarily increase the demand for manpower.

The increased supply potential can be illustrated by a change of the Z-curve in figure 3. It moves as mentioned above to the right in the diagram when labour productivity and the capital stock are increased. If the increased supply potential arises from an increased factor productivity (decreased marginal costs), then the Z-curve will rather have a tendency to move downwards (swing to the right), which will also increase the effective demand for labour measured in units of efficiency. Hence, what we do not really know is, how labour and capital efficiencies evolve through time.

Even under the assumption of an unchanged AD-curve, the effective demand for output will increase when the Z-curve is moved to the right. If productivity is increased, then the intersection point between the AD and Z-curves will move – *ceteris paribus*<sup>7</sup>. This is due to the fact that the intersection point between the production that the firms expect to sell (AD) and the costs of undertaken the production (the Z-curve) is moved, which causes an increase in effective demand for production. On the other hand, nothing unequivocal can be said about the employment effect, because the increased productivity drives a wedge between production and employment. Production can be increased, without it automatically leading to increased employment. It is a well-known empirical phenomenon and is called 'jobless' growth. In order to determine the employment effect, the connection between production and employment must be continuously corrected for the changed productivity.

An increased effective demand for production is thus not in itself a guarantee for increased employment in a growth perspective with increased work productivity. This requires that effective demand increases faster than labour productivity. Increased employment is therefore dependent on the expected volume of sales running faster than the development in labour efficiency.

What can be said about sustainable development? Unfortunately, very little. If the copper price in twenty years time is something of which we will say, that 'we simply do not know', then the physical living conditions in 100 years time is something that we *really* do not know. Uncertainty prevails. On the other hand we could repeat Keynes's thought experiment. How could we take stock of increased productivity inherently in the capitalist market system? Business as usual means that aggregate demand has to grow with the same speed – doubling the GDP ever 40 years (a little less than 2 percent annual growth).

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<sup>6</sup> Within *the Economic Possibilities of our Grandchildren*, mentioned above, he made a calculation of a trend-increase in productivity of 2 percent p.a. - which quadruples production capacity in 70 years (two generations). Then he asked the question, if we accept the living standard of today (1930), then we could reduce the daily/yearly working time considerably – and concentrate on Love, Beauty and Truth, which could also be considered as a kind of sustainable way of life!

<sup>7</sup> Here, the OSCP method is used, which is therefore just one step in a longer chain of reasoning.

An alternative is to stop aggregate demand from growing in the future. That would lead to falling rate of profit, stagnating real investment unless the aggregate demand is directed towards energy conservation and durable energy production without necessarily reducing the material living standard.

In some way it is due time to stop any further expansion of private consumption in the rich countries, because increased physical consumption seems not to make people any happier, perhaps even to the contrary due to externalities, (Layard, 2005). On top of that we know with reasonable certainty that the size of the global population in the developing countries will continue to grow for the coming 30-40 years with another 3 bill. people. If we further assume a rising living standard for all people in the developing countries to a level which is equivalent to the average of the OECD-countries of today say \$ 30.000/year, then global GDP has to grow quite substantially before it, by the end of this century, might stabilise at a much higher level.

But, if the rich countries would use all their future productivity gains (excess capacity) to protect the global environment by energy conservation and pollution reduction – their might be a chance of a reduced uncertainty with regard to sustainability (at least with regard to the greenhouse effect) for the following century, which is the time period where our grandchildren are expected to live. What the living conditions will be in other perspectives: water supply, urban life and incurable diseases, ‘we simply do not know’; but living conditions will be rather differently distributed around the globe. Some continents will be relatively unexploited and ‘under-populated’ which might cause other tensions and attempts to migration.

The macroeconomic system is not self-adjusting. If we include the consideration of the exhaustible frame of natural resources and unpolluted environment the economy as a whole will become even less self-adjusting, but presumably follow an unpredictable, but path-dependent track into a seemingly more and more uncertain future. This means that the decisions we undertake (or do not undertake) today will have irreversible implications for the future. That is one of the less uncertain prediction related to the prevalent unsustainable development which is taking place right now, especially as long as policy decisions are building upon the conventional general equilibrium assumption that nature is economically unlimited, then the attitude that business as usual can go on unchallenged into the future will prevail.<sup>8</sup>

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<sup>8</sup> One may recall the fate of Titanic. Some of us are travelling on first class, other on second class and the crowd on low economy class. When then iceberg is hit, there will only be room in the rescue boats for a section of those travelling on first class, the other passengers are left behind on the sinking boat with decreasing chances of survival. The unfortunate thing is, that it is only people at first class, who have the economic power to change the course of Titanic; but they have the least incentives to do anything!

## Conclusion

*I shall argue that the postulates of classical theory are only applicable to a special case only and not to the general case, the situation which it assumes being a limiting point of the possible positions of equilibrium. Moreover, the characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the fact of experience, (Keynes, 1936: 3).*

*The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes. The bearing of the foregoing theory on the first of these is obvious (Keynes, 1936: 426).*

Keynes did present an analytical alternative to the prevailing neoclassical general macro-equilibrium framework. In this paper I have argued, that the real difference was the incorporation of *individual uncertainty* into the macroeconomic analysis.

The ‘principle of effective demand’ is one of the major examples demonstrating that taking uncertainty seriously means getting new theoretical insights. The importance of effective demand cannot be understood without explicit reference to uncertainty in entrepreneurs’ decision making process.

Very little can be said about the longer run perspective other than it depends on decisions taken to day especially concerning institutions and supply structures. With regard to sustainable development we can hardly know anything, except that uncertainty is increasing the faster we change the actual situation by resource exploitation and increased pollution. Furthermore, it seems quite likely that poor people and poor countries will be hit the hardest through deteriorating living conditions. Whereas, those countries, which have the economic excess to undertake real environmental changes, have the least incentives to do so – they are in a stronger position to protect themselves against the negative impact of changed climate and increased migration.

The private sector cannot on its own plan for a sustainable future, because effective demand is a principle based on short term profit maximising. Keynes, 1936: chapter 24 concluded convincingly that the principle of effective demand causes the market economy to behave in an unstable way even in the short run, and it is not even able to provide for full employment and a decent distribution of wealth and life opportunities.

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